

REPORT OF THE
OFFICE OF THE AUDITOR GENERAL
TO THE
JOINT LEGISLATIVE AUDIT COMMITTEE

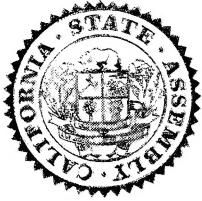
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DEPARTMENT OF VETERANS AFFAIRS

* * *

AN ANALYSIS OF THE CAL-VET
LOAN PROGRAM'S NEED
TO MAINTAIN A CONTINGENCY RESERVE

JUNE 1976



Joint Legislative Audit Committee

OFFICE OF THE AUDITOR GENERAL



California Legislature

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June 9, 1976

The Honorable Speaker of the Assembly
The Honorable President pro Tempore of
the Senate
The Honorable Members of the Senate and the
Assembly of the Legislature of California

Members of the Legislature:

Your Joint Committee respectfully submits the Auditor General's analysis of the need for \$70-80 million contingency reserve fund from Cal-Vet Bond sales. Should the California Veterans Board rescind its reserves policy, 2800 additional Cal-Vet home loans could become available.

Attached to the report is a classic example of bureaucratic gobbledegook prepared by the California Veterans Board. The writer of the last sentence on Page 23 (-10-) has obviously never attended meetings of the Assembly Committees on Public Employment and Veterans Affairs and on Government Organization since 1967 where lawmakers have been told periodically that the Cal-Vet program was running out of money and loans had been curtailed.

Respectfully submitted,

MIKE CULLEN, Chairman
Joint Legislative Audit Committee

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SUMMARY

In 1970, the California Veterans Board adopted a policy of maintaining a contingency cash reserve equal to one-half the annual Cal-Vet bond principal and interest payments due in the following year. The reserve is cash that is not used to make loans to veterans, but instead is invested in the State's Surplus Money Investment Fund. Currently, \$80 million is maintained as a contingency reserve.

This report describes why the large cash reserve is unneeded and points out that other procedures are available for meeting temporary cash needs.

Eliminating the Board's contingency reserve during calendar year 1976 would free \$80 million for loan purposes, at a time when the projected demand for new loans exceeds the availability of loanable funds by \$200 million. We recommend specific action by the California Veterans Board and the Department of Veterans Affairs.

INTRODUCTION

In response to a legislative request, we reviewed the Department of Veterans Affairs' practice of maintaining large cash balances to provide a reserve for unforeseen contingencies in the Cal-Vet loan program.

The Cal-Vet loan program was established in 1921 to provide California war veterans with low-cost housing and farm loans. Qualified veterans are charged the lowest possible interest rate which the Department determines will cover the costs of the program. The current interest rate for new loans is 6.25 percent. The program is financed solely through bond sales and veterans' loan payments without cost to the California taxpayer.

In fiscal year 1974-75, Cal-Vet made 7,382 new loans worth \$172 million. As of March 1976, 116,000 loans were outstanding with a loan value of \$1.4 billion.

FINDING

SINCE IMPLEMENTATION OF A CONTINGENCY RESERVE POLICY IN 1970, THE DEPARTMENT OF VETERANS AFFAIRS HAS MAINTAINED EXCESS CASH BALANCES. CURRENTLY \$80 MILLION IS REQUIRED TO BE MAINTAINED AS A RESERVE UNDER THIS POLICY.

The California Veterans Board supervises the Department of Veterans Affairs' Cal-Vet loan program. In July 1970, the Board adopted a policy of maintaining a contingency cash reserve equal to one-half the amount of bond principal and interest payments coming due in the following year (six month's debt service). The contingency reserve is cash that is not used to make loans to veterans, but instead is invested in the State's Surplus Money Investment Fund. Without this Board policy, the Department could make approximately 2,800 additional loans.

In fiscal year 1975-76 total debt service payments are just over \$160 million. Therefore, the minimum cash balance required to be held as a contingency reserve is \$80 million. Since 1970, the Board's policy has required an average of \$73 million to be set aside as a contingency reserve.

Satisfying the Board's contingency reserve policy allows funds to accumulate beyond predictable operating expense and debt service requirements. When the availability of funds is insufficient to meet the demand for new loans, the Board's policy means that some

veterans must either delay purchasing a home or obtain more costly financing. In calendar year 1976, the Department projects that the demand for new loans will exceed the availability of loanable funds by \$200 million.

The need for a contingency reserve of one-half of the annual debt service was never clearly established, and the policy was implemented without the benefit of a financial study of cash requirements.^{1/} Our updated analysis shows that a contingency reserve is unneeded. Cal-Vet receipts and disbursements are highly predictable, and other procedures for obtaining temporary cash are available.

Predictable Cash Flow

The timing and amount of most Cal-Vet cash transactions are known far enough in advance to allow the Department to predict cash flow with a high degree of accuracy. This advance knowledge gives the Department an adequate opportunity to maintain enough cash to meet future commitments without the contingency reserve.

Disbursements

The Department's largest continuing required cash outlay is the debt service payments that are due four times each year. Since the payment schedule for debt service is established when bonds

^{1/} Auditor General's Report No. 146, "Veterans Farm and Home Loan Fund of 1943, Report on Review of Operations, March 1973".

are sold, the exact amount of each debt service payment is known years in advance.

The Department's second largest continuing required cash outlay is the twice yearly property tax payments to county tax collectors. Based on the amount of these payments in prior years and a knowledge of existing current tax rates and assessed valuations, the amount of these payments can also be reliably estimated in advance.

During 1974-75, excluding the amounts disbursed for new loan purposes, debt service and property tax payments accounted for 98 percent of the Department's cash outlays. The remaining two percent of cash outlays consisted of net operating costs which are stable from month to month. (Disbursements for life, disability and fire insurance premiums were omitted from this analysis since these payments are offset by loan receipts from veterans and have an insignificant effect on cash flow.)

Receipts

Due to a history of faithful loan payments by veterans and an established pattern of early retirement of Cal-Vet loans (prepayments), the Department's cash receipts are only slightly less predictable than disbursements. Loan defaults have been insignificant, and since July 1970 late payments have never exceeded 4.4 percent of the loans outstanding in any month.

Since July 1970, the only significant variable in loan receipts has been monthly prepayments. The variability of monthly prepayments is insignificant, however, in terms of overall cash receipts. In almost six years, the largest negative deviation was only \$1.6 million, or 11 percent of the average monthly loan receipts.

The risks of over-estimating prepayment receipts can be minimized by forecasting. For example, to analyze the Department's minimum cash flow requirements, we reviewed the variation in prepayments from July 1970 through March 1976. The lowest monthly prepayment rate was 62 percent of the prior year's monthly average. Thus, forecasting based on historical experience can reliably predict minimum prepayments up to a year in advance. More sophisticated forecasting techniques, such as economic trend analysis and seasonal fluctuation studies, would increase accuracy and lead time.

Excess Funds Over Needs

During the 68-month period between July 1970, when the Board adopted its contingency reserve policy, and February 1976, the Cal-Vet program has maintained a monthly average cash balance of \$94 million in excess of minimum cash requirements. This is \$14 million in excess of the current Board policy requiring a contingency reserve of \$80 million and \$21 million in excess of the average contingency reserve of \$73 million required by the Board since 1970. The contingency reserve was fully accumulated as of June 1971. On two occasions, October 1973 and March 1974, part of the contingency reserve

was temporarily used for cash outlays. However, the Department immediately replenished the contingency reserve from bond proceeds that were being processed by the State Treasurer at the time the cash was used. Based on a "worst-case" forecast comparing Cal-Vet actual monthly cash outlays to the lowest monthly loan receipts and prepayments during the 68 months, Cal-Vet experienced a monthly average excess cash balance of \$93.7 million.

Although the \$94 million balance illustrates the magnitude of cash retained since the contingency reserve policy was established in 1970, it does not demonstrate the unevenness of monthly cash requirements. Whereas total monthly loan receipts do not vary greatly, cash outlays are higher in some months than in others. Consequently, cash received during months when cash outlays are low are accumulated to meet large cash outlays required in other months. For example, each year large cash payments are required to pay scheduled bond principal and interest payments at the end of January, March, July and September and to pay property taxes in April and December. During the other months of the year, much smaller cash outlays are needed, and the Department accumulates cash to make the larger payments. Because of fluctuations in cash payments, month ending cash balances also fluctuate.

Annually the Department estimates cash receipts and disbursements for several subsequent fiscal years. These estimates provide projections of net cash receipts from operations, new bond sales and investments, and of disbursements for debt service and operating costs. A monthly projections of cash receipts and

disbursements would provide the Department with a current and reliable estimate of cash needs. A monthly projection of cash needs would also provide a safeguard against changes in economic conditions that might have a material effect on the operations of the Department. Projecting cash needs monthly would make it unnecessary to maintain a contingency reserve beyond foreseeable operating needs.

Emergency Cash Resources

If a miscalculation in forecasting occurs or an unpredictable emergency arises, the Department has several methods of increasing short-term cash flow. The Department can (1) delay commitments on applications for new loans, (2) request the Veterans Finance Committee to ask the Treasurer to advance the date for bond issuance,^{2/} and (3) borrow from the State Treasury.

The Department can control cash flow by delaying commitments on applications for new veteran loans. In fiscal year 1974-75, for example, loan commitments averaging \$14 million monthly could have been delayed if an emergency cash shortage had arisen.

Bond proceeds are a second cash resource. The Department can realize bond proceeds by requesting the Treasurer, through the Veteran Finance Committee, to advance the issue date of unsold veterans' bonds. Proceeds from a bond sale can be available less than one month after the sale is authorized. Because of investors' high preference

^{2/} The Veterans Finance Committee is composed of the Governor, State Controller, State Treasurer, Director of Finance and Director of Veterans Affairs and is required by Section 991 of the Military and Veterans Code to determine the need for bond sales.

for California general obligation bonds, veterans' bonds can normally be sold with less than one month's notice to potential bidders.

In the event these two supplemental cash resources would prove insufficient to meet temporary cash needs in an emergency, the Department is further protected by its ability to borrow from the State Treasury. The State Treasury normally has cash resources of \$1 billion to \$2 billion, a part of which can be loaned to special funds whose cash resources have been exhausted.

Comparable Oregon Program Maintains No Reserve

Oregon, which has the only other veterans loan program comparable in size to California, does not maintain a contingency reserve. Oregon's reserve policy is stated in its April 1976 bond sale prospectus:

The department has no policy for maintaining permanently restricted, inactive reserves. Surpluses accumulated over the department's existence...are rolled back into mortgage loans and are considered by the department sufficiently available to meet cash needs as they develop. Six-month cash projections are updated every month.

CONCLUSION

In a program intended to provide low-cost home and farm loans to as many qualified veterans as possible, maintaining large cash balances in excess of need prevents some veterans from obtaining loans. The proven stability and predictability of the Cal-Vet

program and its ample emergency resources make the Department's "contingency reserve" unnecessary.

RECOMMENDATIONS

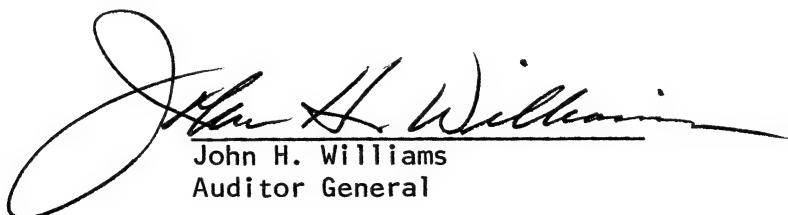
We recommend that the California Veterans Board terminate its policy of maintaining a "contingency reserve" in the Cal-Vet loan program.

We further recommend that the Department of Veterans Affairs use forecasting techniques to minimize cash balances maintained in the Cal-Vet loan program.

BENEFIT

If the Department's contingency reserve policy is eliminated, another \$80 million will be available for home and farm loans to qualified veterans.

Respectfully submitted,



John H. Williams
Auditor General

June 1, 1976

Staff: Robert Neves
Curt Davis
David Tacy

RESPONSE TO
AUDITOR GENERAL'S REPORT

A closing conference was held with the Director, the Deputy Director, and the Manager of the Division of Farm and Home Purchases on May 25, 1976. During this conference, the Department agreed with the report except for some minor technical wording. We concurred and made the suggested changes. The Department indicated specific action by the California Veterans Board would be required before the contingency reserve could be eliminated.

The Department did not provide a written response to the report. The attached unsigned "Response to the Report of the Office of the Auditor General" was received from the Secretary to the California Veterans Board.

DEBT SERVICE RESERVE

**A Response to the Report of The
Office of the Auditor General**

CALIFORNIA VETERANS BOARD

May 1976

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INTRODUCTION

The California Veterans Board has adopted a policy to maintain a cash reserve to pay debt service. This policy has been in effect since 1970 to the benefit of the Department. The Office of the Auditor General has prepared a report to the Joint Legislative Audit Committee in which it is recommended that the Board rescind this policy and that the Department of Veterans Affairs use forecasting techniques to minimize cash balances maintained in the Cal-Vet loan program.

In making this response a general discussion of a debt service reserve is necessary and a critique of specific points made in the report of the Office of the Auditor General is imperative.

THE POLICY

Originally adopted in 1970, the reserve policy was amended several times, most recently on September 19, 1975. The policy now reads:

"A cash reserve of the Cal-Vet Farm and Home Loan Fund shall be maintained at a ratio of 50 percent of the annual debt service. The funds shall be invested and those funds that accrue through interest shall be used for additional Cal-Vet loans. The Department may borrow from the reserve to pay debt service only and the full amount borrowed shall be immediately repaid upon the subsequent sale of Veterans bonds. The California Veterans Board shall review the reserve ratio and amount on an annual basis."

It is a generally accepted fact that the managers of an organization (public or private) must make certain that adequate cash funds are available at all times. Good management requires that sufficient cash be available for the timely payment of invoices, payrolls, and other costs and operating expenses. An adequate cash balance is also essential to maintain a good credit rating. But excessive cash balances, particularly during inflationary periods when cash suffers a loss of purchasing power, indicates ineffective management of cash resources.

The regular cash needs of the Department should be anticipated to ensure that purchases and expenses can be met promptly; that bond interest and principal can be paid; that taxes can be met; that cash is available to fund new loans; and that excess funds, if any, are appropriately invested. The use of the debt service reserve is our management tool

that is utilized to ensure effective use of the Department's cash assets.

Proper cash management requires a projected plan, or cash forecast, for a number of months in advance. The Farm and Home Purchases Division maintains such a forecast which is updated monthly. The California Veterans Board has received monthly updates of this cash flow projection, in written form, in the past and regularly reviews these figures even when not requested in this form.

As the report of the Office of the Auditor General points out, "The timing and amount of most Cal-Vet cash transactions are known far enough in advance to allow the Department to predict cash flow with a high degree of accuracy." This is certainly true and it is being done. These highly accurate projections are utilized in reviewing the operations of the Department and in reference to the debt service reserve.

The need for such a reserve is clearly established by the very fact that the Department must make debt service payments. It is a fact that the Department knows with certainty the amount and timing of these payments. Knowing these facts, then, efficient management calls for ensuring that sufficient funds are available to meet these debt service payments. While the three methods for increasing short-term cash flow are comforting as means of meeting emergency cash needs, they do not mitigate against management's responsibility to maintain sufficient cash to meet these payments. Thus, this cash cannot be used to make additional Cal-Vet loans as it must be set aside for debt service purposes.

Having been set aside, or earmarked, for use in making debt service payments, this cash is in effect of no immediate use to the Department.

Prudent management requires that these excess funds be invested rather than lie dormant. As a public entity, it is not the Department's purpose to realize profits and it is therefore appropriate that these funds be invested, in accordance with the law, in the relatively riskless State Surplus Money Investment Pool.

While the rate of return on these invested funds varies, an assumption of a six percent return will suffice for this discussion. On 80 million dollars, the present reserve, this return would amount to \$4.8 million annually. At an average lending rate of \$30,000, this interest income generates 160 additional Cal-Vet loans per year. It should be recalled that the Board's policy clearly states that this is the only purpose to which interest income can be put. It should also be kept in mind that the reserved funds could not be utilized to make loans as they are needed to meet debt service.

In addition to being prudent management practice and generating additional loans from funds that could not otherwise be used for making loans, the use of the reserve has other advantages. Certainly, it impacts on the security of the bond holders investment. By reserving funds that must be utilized to pay debt service, the investor is given additional security. This security affects the credit rating of Cal-Vet bonds and thus the State as a whole. Further, this affects the ease with which Cal-Vet bonds can be sold. While the impact of this added security may be negligible at times, it certainly is never detrimental or dysfunctional.

Further, the California Veterans Board has spent four years attempting to implement the Legislature's mandate to utilize participation

contracts in the Cal-Vet program. Such implementation will inevitably require the establishment of some form of security reserve. While the reserve that is finally established, if the program is implemented, may be in different form, the present reserve plays an important role in establishing in the minds of potential participants the Department's commitment to maintaining fiscal responsibility.

Finally, it must be stated that the maintenance of this reserve has not caused fewer loans to be made. As the report points out: "During the 68-month period between July 1970, when the Board adopted its contingency reserve policy, and February 1976, the Cal-Vet program has maintained a monthly average cash balance of \$94 million in excess of minimum cash requirements. This is \$14 million in excess of the current Board policy requiring a contingency reserve of \$80 million and \$21 million in excess of the average contingency reserve of \$73 million required by the Board since 1970". Thus, on the average, the Department had \$21 million of excess cash to meet loan demand in spite of maintaining a reserve. Further, by having a reserve to rely upon, the Department has been able to maintain a steady rate of processing loan applications. This is evidenced by records of the Department. There have been occasions, even recently, when bond sales have been postponed due to other considerations. At such times the Department has been able to utilize all available funds to make loans because management could utilize the debt service reserve to meet debt service. This has certainly been to the benefit of veterans who would otherwise be subject to delays or to having to obtain other more costly means of interim financing.

Having reviewed the Board's policy, the need therefore, and its beneficial consequences, it is now appropriate to address specific items of the report of the Office of the Auditor General. In doing so, the format of that report will be followed.

CONTENTS OF REPORT

1. FINDING

The report states: "Without this Board policy, the Department could make approximately 2,800 additional loans." However, it is clear that this is an unwarranted conclusion. The Department would still have to use the reserved funds to meet debt service and, thus, could not make additional loans. Further, interest income would be lost which actually does allow the Department to make additional loans and management would be open to criticism for inefficient cash management.

This section also states: "Satisfying the Board's contingency reserve policy allows funds to accumulate beyond predictable operating expense and debt service requirements. When the availability of funds is insufficient to meet the demand for new loans, the Board's policy means that some veterans must either delay purchasing a home or obtain more costly financing."

The first statement as to accumulation of funds is true only to the extent of the interest earned on the reserve. This interest is regularly collected by the Department and used to make additional loans. The second is refuted by the report itself which states that an average \$21 million of excess cash has existed beyond the reserve amount and by

the fact that not one such case has occurred since the inception of the reserve as a result of its establishment.

This section also states: "The need for a contingency reserve of one-half of the annual debt service was never clearly established, and the policy was implemented without the benefit of a financial study of cash requirements." This statement is justified by footnoting a previous report. However, it was not even copied correctly. The 1973 report states: "The need for a contingency reserve in the amount of one-half of the annual debt service has not been clearly established. To the best of our knowledge, the amount of reserve was established without benefit of a financial study of cash requirements." Even the 1973 statement was not backed with facts and thus reflects merely a speculation. In the preparation of both reports, no Board member, nor the Assistant to the Board, were queried in regard to this statement.

In fact, the Board's selection of the 50 percent factor was predicated upon the initial assumption that a reserve was necessary. With that fact in mind, a reserve amount was, at best, a subjective decision and was based upon a close study of the aforementioned highly accurate cash flow projections of the Department. Since past experience had shown that the occasions when the reserve would be needed were those when either bonds needed to be sold or the program was without funds to continue loaning, the key factor was the amount of time needed to sell veterans bonds as in the other case, there would be none to sell.

Experience had also shown that the process of selling veterans bonds is more time consuming than Report 279 would lead one to believe. First,

the Veterans Board must be alerted to the need and take appropriate action. Since, in other than emergency situations, the Board meets monthly, this process can take as much as one month to complete. Even if the Department is fortunate enough to be able to arrange for a meeting of the Veterans Finance Committee simultaneously, the busy schedules of the individuals involved often requires an additional months time. Having been authorized for sale, a prospectus must be prepared and the offering put out to bid. If no delays are encountered in this process, and past experience shows they often are, another month has elapsed. Finally, the bonds can be printed and the proceeds realized in about one more month. Thus, if no problems are encountered, four months is a reasonable estimate of the amount of time needed to complete the process of selling authorized bonds. Adding a margin of two months to allow for unforeseen delays is not inappropriate.

It is true that if an emergency existed, it may be possible to expedite these matters. However, to be so remiss in one's management responsibilities as to allow this type of situation to continually become a crisis, would soon generate much more criticism based upon facts than can now be generated in reference to the reserve.

2. PREDICTABLE CASH FLOW

This section points out that "advance knowledge gives the Department an adequate opportunity to maintain enough cash to meet future commitments without the contingency reserve". This is true. However, it has already been pointed out that prudence calls for investing this excess cash.

The next three sections of the report point out, basically, that the Department's cash receipts and disbursements can be accurately predicted. In fact, they have been and are accurately predicted. It is also stated that: "More sophisticated forecasting techniques, such as economic trend analysis and seasonal fluctuation studies, would increase accuracy and lead time". This is true and will be given consideration by the Veterans Board.

Finally, one of these sections states that: "Projecting cash needs monthly would make it unnecessary to maintain a contingency reserve beyond foreseeable operating needs". This statement has no basis in fact. The usefulness of the debt service reserve has already been discussed. Monthly projections are being utilized. These three sections clearly indicate: the accuracy with which Department projections can be prepared; that excess cash to meet loan demand exists beyond the reserve; and, therefore, the need to invest surplus funds.

3. EMERGENCY CASH RESOURCES

This section points out three methods whereby the Department can increase short-term cash flow. While these short-term measures allow some flexibility, they provide no basis for an efficient cash management system.

The first such method is to delay commitments on applications for new loans. This, of course, forces the veteran to resort to delay buying a home or to utilize more costly interim financing. Both of these consequences are seen as abhorrent elsewhere in the report. The Department would be remiss to utilize this method except when all other

courses of action are exhausted. The method has, unfortunately, been utilized in those situations where this was the only option remaining.

The second method is to "request the Veterans Finance Committee to ask the Treasurer to advance the date for bond issuance". This is unnecessary with proper planning. While bonds are being sold at planned intervals, the Department can utilize existing cash to continue to make loans and utilize the reserve to pay any amounts of debt service that cannot be paid out of any excess that may exist. The reserve has been utilized in precisely this manner in the past. This is one purpose of the reserve.

Having taken this course of action, the Department will soon thereafter realize the proceeds of a bond sale. Since these sales are usually in rather large amounts, an immediate cash surplus is created. Prudent management calls for investing this excess cash. The Board's policy allows the Department to do so by replacing any amounts borrowed from the reserve. In fact, were it possible, the most prudent course of action would be to sell all of the bonds as soon after authorization as possible and to invest the several hundred million dollars excess to earn interest which would generate more loans for the amount of bonds authorized.

The third method is to borrow from the State Treasury. Again, as with the other methods, this would prove to be a rather unrealistic method upon which to base a cash management system. Certainly, should all else fail, this method would be (and has been) utilized. This short-term measure does not mitigate against management's responsibility for efficient cash management.

4. OREGON PROGRAM

The reserve policy of the State of Oregon's veterans loan program is stated here apparently as justification for a finding that no reserve is needed. There is certainly no logic to such an inference. Inefficiency on the part of one organization does not justify the adoption of a similar course of action by another. In fact, the Department of Veterans Affairs of the State of California can state:

"The Department has no policy for maintaining permanently restricted, inactive reserves. Surpluses accumulated over the Department's existence. . . are rolled back into mortgage loans and are considered by the Department sufficiently available to meet each cash needs as they develop." The Department, through its debt service reserve, provides additional investor security and is able to make more loans to veterans by utilizing the interest income earned on the reserve.

5. CONCLUSION

This report concludes: "Maintaining large cash balances in excess of need prevents some veterans from obtaining loans. The proven stability and predictability of the Cal-Vet program and its ample emergency resources make the Department's contingency reserve unnecessary".

It should be sufficient to point out that if there are large cash balances in excess of need, no veteran could possibly be prevented from obtaining a loan. The need for cash includes the need to fund existing qualified loan applicants. Since its inception, the reserve has not caused a single veteran to be denied a loan, and it has, in fact, created additional loanable funds.

Concluding that excess cash need not be invested is also unwarranted. Efficient cash management demands that it be and the more the better.

6. RECOMMENDATIONS

A recommendation to terminate the Board's policy is not supported by this report. A recommendation that more sophisticated forecasting techniques be used to minimize cash balances maintained in the Cal-Vet loan program is noteworthy and will be pursued by the California Veterans Board.

7. BENEFIT

It has already been pointed out that moving reserved funds to another location, where no interest is earned, does not create additional funds for loans. The funds would still be needed to meet debt service.

CONCLUSION

It is clear that the California Veterans Board's debt reserve policy was based upon sound information, reflection, and management principles. It has proven itself to be an efficient cash management tool. The interest income has provided additional Cal-Vet loans and the reserve has not caused fewer veterans to receive loans or to be delayed in funding.

It is perhaps due to the original name, "contingency reserve", that misunderstanding of its purpose has developed. It is, admittedly, a name that implies uses other than those envisioned by the Board. A review of the Board's policy statement, quoted earlier, reveals important factors.

First, this is a reserve to pay debt service. Earmarking cash for this purpose is obviously required. These earmarked funds are to be invested, rather than lie dormant. The interest earned is to be used to make additional loans. The Department may use these funds to pay debt service. The policy places no other restriction on the use of these funds. The Department is free to use its discretion as to the timing and advisability of such use. Having been so used, the fund is to be replenished.

When the Department is able to fund loans and to pay debt service from excess cash not placed in the reserve, and this is the usual case, these additional excess funds are earning interest. When this is not possible, and this has occurred, the Department is able at any time to reach into the reserve and draw out up to the total amount in the reserve in order to meet debt service while simultaneously using all other cash assets to continue to make loans.

Although the report of the Office of the Auditor General contains no apparent basis for concluding that the Board should terminate its Debt Service Reserve Policy, the California Veterans Board is appreciative of the effort and time expended in attempting to ensure that the Cal-Vet program provides maximum benefit to the veterans of this State. Therefore, the Board will continue to review this report and give due consideration to pertinent points raised therein.

APPENDIX 1 - CASH FLOW PROJECTION

This appendix contains a cash flow projection for the Cal-Vet program for eleven months. It indicates that if the Department is able to sell the remaining \$75 million in authorized bonds in July, as planned, the Department will be able to continue to fund loans in spite of the debt service reserve. It also shows that the Department will have to plan to sell bonds authorized in the June primary in time to realize the proceeds of this sale by March 1977.

However, it should be noted that if unforeseen delays occur in either July, 1976 or March, 1977, the debt service reserve will be more than sufficient to meet debt service at that time. Thus, the Department can continue to use all other cash assets to fund loans without interruption. This projection is updated monthly to reflect the actual experience of the past month.

[The \$75 million that is to be sold in July is added into the beginning cash balance for August.]

CASH FLOW PROJECTION
(Thousands of Dollars)

	May 1976	June	July	Aug.	Sept.	Oct.
Cash Payments	\$ 70,293 16,000	\$ 71,293 16,000	\$ 72,293 16,000	\$ 109,259 16,000	\$ 110,459 16,000	\$ 68,417 16,000
Prepayments	6,000	6,000	6,000	6,000	6,000	6,000
Investment Income	<u>900</u>	<u>900</u>	<u>900</u>	<u>1,100</u>	<u>1,100</u>	<u>900</u>
Total	\$ 93,193	\$ 94,193	\$ 95,193	\$132,359	\$133,559	\$ 91,317
Operating Expense	\$ 280	\$ 280	\$ 280	\$ 280	\$ 280	\$ 280
H.P.P. Premiums	1,280	1,280	1,280	1,280	1,280	1,280
F & H Premiums	340	340	340	340	340	340
Loans (est.)	20,000	20,000	20,000	20,000	20,000	20,000
Debt Service	0	0	39,034	0	43,242	0
Taxes	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Total	\$ 21,900	\$ 21,900	\$ 60,934	\$ 21,900	\$ 65,142	\$ 21,900
Balance Reserve	71,293	72,293	34,259	110,459	68,417	69,417
- Total	<u>80,000</u>	<u>80,000</u>	<u>80,000</u>	<u>80,000</u>	<u>80,000</u>	<u>80,000</u>
Total	\$151,293	\$152,293	\$114,259	\$190,459	\$148,417	\$149,417
	<u>Nov.</u>	<u>Dec.</u>	<u>Jan. 1977</u>	<u>Feb.</u>	<u>March</u>	
Cash Payments	\$ 69,417	\$ 70,417	\$ 48,917	\$ 14,717	\$ 15,417	
Prepayments	16,000	16,000	16,000	16,000	16,000	
Investment Income	6,000	6,000	6,000	6,000	6,000	
Total	<u>900</u>	<u>700</u>	<u>600</u>	<u>600</u>	<u>600</u>	
Operating Expense	\$ 280	\$ 280	\$ 280	\$ 280	\$ 280	
H.P.P. Premiums	1,280	1,280	1,280	1,280	1,280	
F & H Premiums	340	340	340	340	340	
Loans (est.)	20,000	20,000	20,000	20,000	20,000	
Debt Service	0	0	35,000	0	38,000	
Taxes	<u>0</u>	<u>22,500</u>	<u>0</u>	<u>0</u>	<u>0</u>	
Total	\$ 21,900	\$ 44,400	\$ 56,900	\$ 21,900	\$ 59,900	
Balance Reserve	70,417	48,917	14,717	15,417	-21,883	
Total	<u>80,000</u>	<u>80,000</u>	<u>80,000</u>	<u>80,000</u>	<u>80,000</u>	
Total	\$150,417	\$128,917	\$ 94,717	\$ 95,417	\$ 58,117	

APPENDIX 2 - HYPOTHETICAL CASE

In this appendix it is assumed that for some reason veterans bonds could no longer be sold. This would, in effect, terminate the Cal-Vet program. If this were a sudden, unexpected event, problems would certainly arise in funding loan commitments. Assuming this occurred on May 28, 1976, the affects can be studied.

Presently, the Department has \$99.2 million in loan commitments and \$5.5 million in escrow. Thus, with this abrupt program termination \$104.7 million would be needed to fund present commitments. The Department's cash balance as of 14 May was \$86 million, not including the reserve. Thus, \$18.7 million would not be covered. The California Veterans Board could at this time allow the Department to use the reserved funds to meet this \$18.7 million commitment and the reserve would then contain \$62.3 million. This excess could be used to make additional loans or for other purposes as deemed appropriate.

Since the veteran's payments are sufficient to pay for all costs of the program, there would be no danger in continuing to administer the program until all loans, and thus outstanding bond interest and principle, were paid in full.

This example illustrates an overlooked aspect of a policy. A policy is nothing more than a standing plan that guides the members of an organization in the conduct of its operations. This policy has proven effective in that regard. However, a policy can be rescinded at any time it becomes dysfunctional. To date, this policy has not become dysfunctional.